Office of Chief Counsel
Internal Revenue Service

# memorandum

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date: August 21, 2000

to: Larry I. Walter
Inventory Technical Advisor

from: Grant E. Gabriel
Counsel to Inventory Technical Advisor

subject: [redacted]

This memorandum responds to your request for assistance regarding the above-referenced case. Specifically, you requested us to opine whether taxpayer used a permissible method of valuing its last-in, first-out (LIFO) inventory of precious metals.

## DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

## ISSUE

Whether [redacted] is prohibited from using published market prices to determine the current-year cost of its specific-goods LIFO increments.

## CONCLUSION

[redacted]'s use of market value instead of cost to value it's specific goods LIFO increments is contrary to the requirement set forth in I.R.C. § 472(b)(2) and underlying regulations, that LIFO inventories must be stated at cost.

## FACTS

[redacted] an accrual-basis taxpayer using a calendar taxable year is in the business of "buying" and selling precious metals. All of [redacted]'s precious metals inventory is obtained through its process of [redacted]

[redacted] maintains joint product costing records for the process it uses to [redacted]. [redacted] values its precious metal inventories using the specific-goods LIFO method. [redacted] uses prevailing market prices on the inventory valuation date to value any increases in its LIFO inventory (increments).

## LAW

Section 446(b) of the Code provides if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 471(a) provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business as most clearly reflecting income.

Treas. Reg. § 1.471-2(c) provides the bases of inventory valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower.

Treas. Reg. § 1.471-3(c) provides in the case of merchandise produced by the taxpayer since the beginning of the taxable year, cost means (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including those costs required to be capitalized under Section 263A.

Treas. Reg. § 1.471-4(a)(1) provides under ordinary circumstances and for normal goods in an inventory, market means aggregate of the current bid prices prevailing at the date of the inventory of the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacture, and finished manufactured goods on hand. The basic elements of cost include direct materials, direct labor, and indirect costs under § 263A.

Treas. Reg. § 1.471-7 provides a taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product.

Section 472(a) provides a taxpayer may use the LIFO inventory goods in an application to use the LIFO method at the time and manner prescribed by the Secretary.

Section 472(b)(2) provides LIFO inventories must be inventoried at cost.

Treas. Reg. § 1.472-2(d)(1)(i) provides that a taxpayer may value LIFO increments (goods on hand of a particular type or class in ending inventory that exceed the number of the same goods in beginning inventory) (1) by reference to the actual cost of goods most recently produced ("most recent purchases cost method"); (2) by reference to the actual cost of the goods produced during the year in the order of acquisition ("earliest acquisitions cost method"); (3) by application of an average unit cost ("average acquisitions cost method"); or (4) pursuant to any other method that, in the opinion of the Commissioner, clearly reflects income.

In *Mountain State Ford Truck Sales, Inc. v. Commissioner*, 112 T.C. No. 7 (March 2, 1999), the Tax Court held the Commissioner properly determined the petitioner's use of replacement cost to value its parts inventory under the LIFO method did not clearly reflect income.

## DISCUSSION AND ANALYSIS

Section 472(b)(2) clearly requires LIFO inventories to be stated at cost. Section 1.472-2(d)(1)(i) permits taxpayers to value specific-goods LIFO increments using the most recent purchases cost method, the earliest acquisitions cost method, the average acquisitions cost method or using a so-called "other" method. In this case, [redacted] values its LIFO increments at market value (defined as published selling price for the particular metal on the inventory valuation date). Thus, [redacted]s method will result in goods for each separate LIFO layer being valued at the market price for the respective year represented by the layer.

In *Mountain State Ford*, the taxpayer use published prices from the manufacture for motor vehicle parts inventories on the inventory valuation date. The Tax Court held the taxpayer was required to use actual cost that, in the case of a reseller, is invoice price.

[redacted]'s facts are materially different from those in *Mountain State Ford* in two respects. First the concept of market is different. In *Mountain State Ford*, the taxpayer in valuing increments at replacement cost at taxable year end was using a value comparable to "market" under the lower of cost or market method set forth in Treas. Reg. § 1.471-4[1]. In contrast, [redacted] is using published selling prices for the commodity on the inventory valuation date. In reality, however, [redacted] does not purchase precious metals in the commodities market. Instead, it purchases [redacted].

In *Mountain State Ford*, the published replacement cost may not have reflected the actual cost of acquiring any of the parts, unless some were purchased on the date in late September or early October when taxpayer took its physical inventory. The published selling prices used by [redacted] are even less likely to reflect [redacted]'s actual production cost at any point in time during the taxable year.

[redacted] may argue that market must exceed its cost in order for it to stay in business during the long term. Nevertheless, selling price is not cost and indeed for any given year, including the base year, fluctuations in the market place could result in market being below cost on any particular date, including the inventory valuation date. Moreover, as a commodities dealer, [redacted] could have elected the mark-to-market method to value its entire ending inventory of precious metals at taxable year end. However, there is no LIFO method that allows taxpayers to mark individual layers to market each year.

The second material distinction between the facts in *Mountain State Ford* and those applicable to [redacted] is that in *Mountain State Ford* the underlying taxpayer was a reseller whereas [redacted] is a producer. Both resellers and producers using LIFO must value inventory at cost. For a reseller, Treas. Reg. § 1.471-3(b) defines cost as the invoice price less trade or other discounts (except cash discounts taxpayer properly opts to deduct on a consistent basis) plus transportation or other charges incurred in acquiring possession of the goods. In addition, a reseller generally has to include other, indirect costs in its inventoriable costs under the uniform capitalization rules. For

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[1]Section 1.471-4(a)(1) defines "market" for purchased goods as the current bid price prevailing at the date of the inventory for the merchandise in the usual volume purchased by the taxpayer. Usually the price is obtained referencing the taxpayer's normal source of supply. Market for manufactured goods is the current bid price of the basic elements of cost (materials, labor and overhead) on the inventory date. In GCM 9401, (1933), X-1 CB 102, the Service concludes that even a manufacturer market is essentially the replacement cost at the last saleable stage plus costs incurred up to the inventory valuation date.

a producer, Treas. Reg. § 1.471-3(c) defines cost as the cost of raw materials and supplies, direct labor and indirect production costs required to be capitalized under the uniform capitalization rules (applicable to a producer).

In *Mountain State Ford*, the taxpayer specifically argued producers are permitted to use standard costs to value their inventories, notwithstanding the fact that standard costs are *estimates* of actual costs. Although the court acknowledged § 472(b)(2) permits the use of the standard cost method to inventory goods at cost, the court also noted significant variances are required to be reallocated on a pro rata basis to goods in ending inventory (under both the full absorption and uniform Capitalization rules) to arrive at actual cost. [redacted] however, is in no way attempting to estimate actual cost. Instead, it is purely using a market price based on published selling prices of various precious metal commodities.

At the same time, however, unlike the taxpayer in *Mountain State Ford*, [redacted] has cost records that could be used to establish the actual cost of its LIFO inventory. [redacted]s method of [redacted] appears to be a joint production process whereby two or more products are produced or derived from the same process. Section 1.471-7 permits allocation of joint product costs with the consent of the Commissioner to allocate cost basis for pricing inventories provided the allocation bears a reasonable relationship to the respective selling values of the joint products.

Original Signed

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